

LAO Issues Rosy Fiscal Outlook for Education

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posted November 19, 2020

Yesterday, November 18, 2020, the Legislative Analyst's Office (LAO) issued its annual, and highly anticipated, Fiscal Outlook on the 2021–22 Budget for California, and the related impact on Proposition 98. Importantly, this is the last preview education budget hawks will have before Governor Gavin Newsom releases his 2021–22 January State Budget Proposal, which he is constitutionally required to do by January 10, 2021.

At the state level, the LAO highlights that the state's economy has undergone a rapid, but uneven recovery. The LAO notes that, although economic consequences of the COVID-19 health crisis were severe, the fiscal fallout was not as catastrophic as many projected in early 2020. Year-to-date tax collections from the "Big Three"—personal income, sales and use, and corporation taxes—are trending 22% ahead of the lowered projections used for the 2020–21 Enacted State Budget. Additionally, new applications for safety net programs, such as Medi-Cal and CalFresh, which typically see increased participation during depressed economic times, are below 2019–20 levels.

The LAO cautions that, although revenues have whipsawed for the better from 2020–21 Enacted Budget levels, the state's revenue growth over the subsequent three years is projected to grow at an average annual rate of less than 1%, while expenditures under current law and policy are projected to grow at an average annual rate of 4.4%. This disparity produces an anticipated operating deficit that will grow to nearly \$17 billion by 2024–25.

Impacts on Proposition 98

The dramatic recovery in "Big Three" taxes above the 2020–21 Enacted Budget levels results in a rosy picture for funding provided under Proposition 98. Because Test 1 is expected to be operative for the foreseeable future—and has been operative for the last couple of years—approximately 38% of General Fund revenues are earmarked for schools and community colleges under Proposition 98. This means that, as the General Fund revenues grow, so too does the Proposition 98 minimum guarantee. Moreover, property tax revenues in a Test 1 environment augment, rather than offset, General Fund revenues, thereby creating a net benefit for K–14 education when property values increase. The LAO estimates, based on its projections, that the 2019–20 and 2020–21 minimum guarantees could grow by \$1.6 billion and \$13.1 billion, respectively, when compared with the 2020–21 Enacted State Budget. Growth at this rate would result in a 2020–21 minimum guarantee that eclipses the historic all-time high in education funding.

	2019-20			2020-21		
	June Budget Plan	November LAO Estimates	Change	June Budget Plan	November LAO Estimates	Change
Minimum Guarantee	\$77,678	\$79,283	\$1,606	\$70,890	\$83,975	\$13,085
Funding Allocations						
Local Control Funding Formula (LCFF)	\$62,707 ^a	\$62,676	-\$31	\$63,037	\$62,565	-\$473
Other K-14 programs	17,151 ^a	17,154	3	18,167	18,164	-3
Savings from payment deferrals	-2,181	-2,181	—	-10,314	-10,314	—
Proposition 98 Reserve deposit	—	—	—	—	1,529	1,529
Totals	\$77,678	\$77,649	-\$28	\$70,890	\$71,943	\$1,053
Settle-Up Payments	—	\$1,634	\$1,634	—	\$12,031	\$12,031

^aAmounts adjusted for Chapter 110 (SB 820, Committee on Budget and Fiscal Review), an August trailer bill that reduced LCFF cost estimates and allocated the savings for additional school meal reimbursements.

Source: LAO 2021–22 Budget: The Fiscal Outlook for Schools and Community Colleges

Given the good fiscal environment, the LAO offers policymakers two key considerations for how to spend this windfall and what obligations exist on the horizon. The first consideration is that, under these revenue scenarios, the Legislature could pay down all the budget deferrals and cover the cost of an estimated cost-of-living-adjustment (COLA) in 2021–22, which is estimated to be 1.14%. This would leave the Legislature with \$4.2 billion for new commitments. Secondly, the LAO notes that pension costs are projected grow quite significantly in 2022–23. The California State Teachers’ Retirement System and the California Public Employees’ Retirement System employer rates are projected to grow more than 2%, and nearly 4%, respectively. The related cost increases range from \$1.3 billion to \$1.7 billion, which would likely exceed the COLA.

As is typical, the LAO recommends that the Legislature adopt a conservative budget approach by appropriating some of the new money for one-time activities. Those one-time allocations could address a range of issues, including mitigating the learning loss experienced by students since the closure of schools in March 2020. However, the LAO advises the Legislature to learn more about how schools and community colleges spent the previous allotment of federal funding before using funds for this purpose.

The LAO also addresses the K-12 school district reserve cap, which according to the forecast, may be triggered going into the 2022–23 year. Assuming that the state continues to collect revenues at the pace forecasted by the LAO, the consequence is that deposits will be made into the Proposition 98 reserves. The total amount of deposits are projected to exceed the threshold—3% of total Proposition 98 spending on K–12 in 2021–22—which triggers the cap on K-12 school district reserves. This historic event would cause many school districts to limit their unassigned plus assigned General Fund reserves to no more than 10% of their annual expenditures.

The unexpected, but welcomed, year-to-date General Fund revenue collections have been a bright spot in an otherwise dismal year that has been dominated by the pandemic. As reported in the November 2020 Finance Bulletin, year-to-date General Fund revenues have outpaced projections by more than \$11.3 billion, but it is important to put that number in perspective. For the LAO’s scenarios to come to fruition, the 2020–21 General Fund revenues must exceed projections by \$33.5 billion, which means the

final seven months of the fiscal year must continue outpacing projections by a total of \$22.2 billion. While that hill is not insurmountable, there are significant challenges and unknowns on the horizon.

Aside from the global and national challenges of which we are acutely aware, there is also uncertainty around the revenue projections that will ultimately be used by Governor Newsom in the 2021 January State Budget Proposal. In a press conference on November 16th, 2020, the Governor acknowledged that General Fund revenues were more than \$11 billion ahead of the 2020–21 Enacted Budget projections, but the question remains: Will he embrace the totality of revenue estimates on par with what was used in the Fiscal Outlook?

As schools and community colleges update their budgets and multiyear projections, we continue to advise that multiple revenue and cash deferral scenarios are absolutely necessary to ensure prudent fiscal planning. And for those hoping the dust will settle in January, hang on, this rodeo is just beginning.